Client Alert 08-047

Tax

Reed Smith Richards Butler

BUDGET 2008
Summary of Changes

If you have questions or would like additional information on the material covered in this Bulletin, please contact the Reed Smith Richards Butler attorney with whom you regularly work, or either of the following attorneys in our **Tax Group**:

Harriet Morgan (London)
ddi: +44 (0)20 7556 6876
hmorgan@reedsmith.com

Fionnuala Lynch (London)
ddi: +44 (0)20 7772 5936
flynch@reedsmith.com

Daniel White (London)
ddi: +44 (0)20 7816 3789
dwhite@reedsmith.com

1. BUSINESS TAX

Corporation Tax Rates

As announced last year the main rate of corporation tax will be reduced from 30 to 28 per cent with effect from 1 April 2008. The Chancellor has now announced that the 28 per cent rate will continue to apply for 2009/2010.

The small companies' rate (for companies with profits lower than £300,000) will be increased from 20% to 21% from 1 April 2008 with further planned increase to 22% from 2009/10

Capital Allowances

The Budget 2008 contains details of a number of changes in relation to the capital allowances regime many of which had already been announced last year. The provisions making these changes will be introduced in Finance Bill 2008 and we now have draft legislation. To re-cap:

- With effect from 1 April 2008:
  - Writing down allowances on general plant and machinery will be reduced from 25% to 20%.
  - Allowances on long life assets will be increased from 6% to 10%.
  - Certain fixtures integral to a building will qualify for 10% writing down allowances only. There will be a list of items and these include electrical, cold water and heating systems, lifts, escalators and moving walkways, ventilation and air purification systems, external solar shading and active facades. Thermal insulation will also qualify for 10% allowances.
- Industrial and agricultural building allowances will be phased out gradually by 2011 with decreasing rates of allowances available over this period. Under the phasing out sales of buildings after 31 March 2007 will not give rise to balancing allowances or charges for the seller. Instead the buyer can claim allowances on the seller's tax written down value. However, with effect from 12 March 2008 the allowances available to the buyer in the phasing out period are to be restricted under new anti-avoidance rules as it appears businesses have been able to manipulate these rules to obtain a tax advantage. The restriction will apply where the seller and buyer are under common control and one of the main purposes of the sale is to gain a tax advantage.
- The enhanced allowances regime for qualifying buildings in designated enterprise zones will also be withdrawn from April 2011 but will not be subject to the phasing out rules. Balancing charges will still apply in relation to qualifying enterprise zone expenditure for disposals within seven years of the first use of the building.
- A new annual investment allowance will commences from April offering all businesses 100% allowances on first £50,000 of qualifying capital expenditure on plant and machinery. Expenditure above this limit will attract further writing down allowances in the usual way. This replaces first year allowances for small and medium enterprises which are being abolished.
- Capital allowance pools of £1,000 or less can be written off so giving a balancing allowance. This prevents business claiming ever small amounts on a continuing basis.
- There are a number of measures aimed at environmental beneficial expenditure. These include:
  - The extension of the scheme enabling 100% capital allowances for the purchase of company cars with low CO 2 for additional five years to 31 March 2013.
  - The extension of the scheme allowing 100 per cent allowances to certain businesses purchasing designated plant and machinery which is energy efficient, reduces water use or improves water quality to further technology areas.

March 2008

www.reedsmith.com

- Provisions for companies to claim a cash payment from the Government in respect of losses generated by claiming 100% first year allowances on designated energy-saving or environmentally-beneficial plant and machinery.

Research and development allowances

As also announced last year research and development allowances will be increased from 150 per cent to 175 per cent for small and medium sized companies and from 125 per cent to 130 per cent for large companies. A cap will be introduced to restrict the amount available for small and medium enterprises to Euro 7.5m per project. The date of these changes has not yet been announced.

Abolitions of taper relief and introduction of entrepreneurs' relief

The Government has confirmed that the proposed capital gains tax changes will take effect. Taper relief will be abolished and a single capital gains tax rate will apply of 18%. The new rules are expected to be included in the Finance Bill 2008. However, the changes will apply for disposals made on after 6 April 2008 with no transitional period.

The Government has also confirmed that a new enterpreneur's relief will be introduced again with effect from 6 April 2008. For qualifying disposals, the tax rate will be 10 per cent, with the balance taxed at the new rate of 18 per cent. The new relief will be a lifetime relief available on multiple occasions for cumulative gains for which the relief is claimed up to £1 million.

The relief applies to disposals of a trading business by individuals carrying on the business (whether alone or in partnership) provided the individual has owned the business or been a member of the partnership for at least one year prior to the disposal. The relief also applies to a disposal of one or more assets of the individual's ore partnership's trading business where the assets are sold within three years of cessation of the trade.

The relief will also apply to disposals of shares and securities in a trading company (or the holding company of a trading group) provided that:

- the individual making the disposal is an officer or employee of the company or of a company in the same group;
- the individual owns at least 5 per cent of the ordinary shares of the company and holds at least 5 per cent of the voting rights; and
- the individual has owned the relevant shares for at least one year prior to the disposal.

Relief is also available in limited circumstances for the disposal of assets used in a business but owned personally where they are disposed of as a result of the taxpayer withdrawing from participating in a company or partnership. Disposals of business assets/shares by trustees will also benefit from the relief in certain circumstances.

We now have draft legislation and examples of how the relief is intended to work in more complex scenarios such as in relation to share for share exchanges taking place before and after the introduction of the new rules. A more detailed note will follow on this.

EIS, Corporate Venturing and Venture Capital Trust

Income tax relief available to investors under the enterprise Investment Scheme ("EIS") will be increased from £400,000 to £500,000. Companies engaged in shipbuilding, coal and steel production no longer qualify for EIS, Corporate Venturing and Venture Capital Trust schemes.

Enterprise management incentives

The individual limit for Enterprise Management Incentives ("EMI") share options to qualify for favourable tax treatment increases from £100,000 to £120,000 for grants of options on or after 6 April 2008. In addition, EMIs will be limited to qualifying companies with fewer than 250 employees. Companies involved in shipbuilding, coal and steel production will no longer qualify for EMI purposes.

Relief for trading losses

Individuals carrying on a trade can, subject to certain restrictions, set off their trading losses against other income and gains (known as sideways loss relief). No sideways loss relief will be available where a loss arises to an individual carrying on a trade in a non-active capacity as a result of tax avoidance arrangements made on or after 12 March 2008. For such individuals where there are no tax avoidance arrangements, there will in any event be an annual limit of £25,000 of sideways loss relief. Individuals who spend an average of less than 10 hours a week on commercial activities of that trade will be acting in a non-active capacity. The restrictions will not apply to losses that derive from qualifying film expenditure (i.e. losses that derive from film reliefs in sections 137 to 140 of ITTOIA 2005) or to losses of a Lloyd's underwriting business.

Taxation of personal dividends from Non-UK Companies

The Government announced last year that from 2008 higher rate taxpayers who own less than 10 per cent of the shares in a non-UK resident company will receive a tax credit reducing their effective rate of tax on such dividends to 25 per cent. It was proposed that this would be limited to cases where the taxpayer receives total dividends of less than £5,000 a year from non-UK resident companies.

The Government has now announced that from 2009 this reduced rate will apply to all higher rate taxpayers in receipt of such dividends and not just those holding less than 10 per cent. Also the £5,000 limit will not be introduced. The lower rate will not apply unless the country in which the company paying the dividend is resident imposes tax on corporate profits and there will be anti-avoidance provisions.

Offshore funds

The Government is proposing a number of measures in relation to offshore funds

- Rules which enable investors in an offshore fund to qualify for favourable tax treatment are to be relaxed. Currently for the investor to qualify for capital rather than income treatment on disposal of their interest in the fund, the fund has to distribute at least 85 per cent of its profits annually. Under the rules the fund will be able to report income to investors rather than distribute it. Further details are not yet available but it is expected that the changes will make the regime less onerous.
- Authorised investment funds (AIF) which invest in non-qualifying offshore funds (as permitted by new FSA rules) will be able to elect for tax treatment to apply whereby the fund will be exempt from tax on gains realised on a disposal of an interest in the offshore fund but the investor will be taxable on the disposal of the interest in the fund as income.
- AIFs which invests mainly in property or certain property vehicles such as in property or UK REITS or similar foreign companies can also elect to move the tax level from the fund to its investors. In brief property rental and other income will not be taxable in the hands of the fund vehicle. Income distributed from the fund will be paid under deduction of tax. Exempt bodies and non-taxpayers can reclaim the tax deducted. Higher rate tax payers and some corporates would have further tax to pay.

Powers, deterrents and safeguards

The Government is proposing to introduce a package of measures aimed at improving its checking, information gathering and penalties regime. These include:

Penalties

From April 2009, a new, single legislative framework will be introduced for penalties for incorrect returns and failing to notify a taxable activity across all the taxes. This regime had already been introduced last year for income tax, capital gains tax and VAT. It will now be extended to all other taxes. For incorrect returns the penalty will be determined by the amount of tax understated, the nature of the behaviour giving rise to the understatement and the extent of the disclosure by the taxpayer. Broadly the new penalties for incorrect returns and for failing to notify a tax liability will be:

- 30 per cent for failure to take reasonable care;
- 70 per cent for a deliberate understatement

- 100 per cent for a deliberate misstatement with concealment.

Penalties may be substantially reduced where the taxpayer makes a disclosure with increased reductions for unprompted disclosures. Where a return is incorrect because a third party has deliberately provided false information or withheld information from the taxpayer with the intention of causing an understatement of tax due, there will be a new provision allowing a penalty to be charged on the third party.

Compliance checks

Legislation will be introduced in the Finance Bill 2008 to reform the rules for checking that businesses and individuals have paid the correct amount of income tax, capital gains tax, corporation tax, VAT and PAYE or claimed the correct reliefs and allowances. The measures will include aligned and modernised record keeping requirements, new inspection and information powers and aligned and modernised time limits for making tax assessments and claims. Full details are not yet available but the measures will include:

- A power enabling HMRC to inspect records required to be kept under record-keeping legislation;
- A power to require supplementary information which is relevant to establish the tax position;
- A power to require third parties to provide information which is relevant to establish the taxpayer's tax position (this power can only be exercised with the consent of the taxpayer or the tribunal);
- A power enabling HMRC to visit business premises and inspect records and assets;
- Removal of VAT and PAYE powers to undertake inspections at private homes without taxpayer consent;
- Rights for the taxpayer to appeal against any penalty or information notice, which has not been authorised by an appeal tribunal;
- Penalties for failure to allow an inspection or to comply with an information notice; and
- An updated criminal offence of destroying or concealing records.

Payments, repayments and debts

There are three aspects to these changes:

- individuals and businesses to pay tax by credit card.
- HMRC will be able to set the repayments it must make to individuals and businesses against the payments it is owed by them. The draft legislation also provides for set-off against amounts due from a "related entity" of the taxpayer (currently undefined); and
- HMRC's debt enforcement powers to collect unpaid sums by taking control of goods in England and Wales or by taking action through the civil courts will be modernised and aligned.

Stamp duty

Exemption of alternative investments bonds

Provisions will be introduced so that alternative investment bonds can be transferred without attracting stamp duty under the exemption which applies to loan capital.

Exemption for capital markets loans

Also loan capital which is subject to a capital market arrangement on limited resource terms will be exempt. This is aimed at allowing securitisation companies to issue loan capital on a limited recourse basis without attracting duty.

Abolition of £5 duty

With effect from 13 March 2008, instruments transferring stocks and shares which were previously subject to duty of £5 will no longer be subject to duty and will not need to be presented to HMRC for stamping. This measure applies to:

- All transfers where the consideration is £1,000 or less and which would formerly have attracted ad valorem stamp duty of £5 or less (provided that such transfer does not form part of a larger transaction or series of transactions in respect of which the aggregate amount of consideration exceeds £1,000); and

- Transfers of shares and securities which formerly attracted a fixed stamp duty charge of £5 such as transfers between nominees, declarations of trust (provided they do not constitute a sale), replacement or second copies of instruments.

Instruments which are exempt from duty under this provision may be sent direct to the company registrar without first being presented to HMRC and no self certificate is required.

2. REAL ESTATE

SDLT

Property investment partnerships

As announced in the Pre-Budget Report 2007, the rules imposing an SDLT charge on a transfer of a partnership interest will be amended. To recap, in this context transfer is widely defined to cover much any situation where an existing partner's interest increases/decreases or where a partner retires. Initially this charge only applied where some form of consideration (again widely defined) was given or deemed to be given. However anti avoidance provisions were introduced in the Finance Act 2007 which impose a charge even there is no consideration for the change in partnership shares and regardless of whether the parties involved in the transaction were connected in any way. These changes were aimed at particular schemes which were being used to avoid SDLT on property sales using partnership structures. However, they also catch perfectly innocent instances where there is a change in partnership shares for no consideration. In response to representation by affected parties HMRC are re-introducing a requirement that for an SDLT charge to apply it will again be necessary for consideration to be provided or for there to be a connection between the parties.

We still do not have draft legislation for this so the full scope of the provision remains clear. Once introduced the provisions will apply retrospectively with effect from 19 July 2007.

Anti-avoidance - Group relief and alternative finance schemes

The Government is introducing measures to block two types of SDLT planning structures. First the group relief clawback schemes will be extended. In outline group relief which applies to exempt from SDLT a land transaction taking place between group companies is clawed back where the purchaser company ceases to be a member of the same group as the seller company within three years of the original intra group transaction. Businesses were avoiding the clawback by arranging for the seller company to leave the group first. The new rules will apply the clawback where the vendor leaves the group and there is a change of control of the purchase company within a three year period of the original intra group transfer.

Secondly the Government is blocking structures which avoid SDLT on property acquisition by using an exemption from SDLT which applies where UK property is transferred by a borrower to a financial institution within the alternative finance regime. Financial institutions had been co-operating with purchasers to exploit this exemption to avoid SDLT on property acquisitions. The exemption from alternative finance structures will no longer apply if there are arrangements in place for a person to acquire control of the financial institution.

These provisions will apply to any transaction completed on or after 13 March or where the transaction is substantially performed on or after 13 March 2008 (broadly where the purchaser takes possession, pays the majority of the price or the first rent or becomes entitled to underlying profits in respect of the property).

SDLT avoidance and disclosure

Last year the Government announced it was considering introducing measures to stop the avoidance of SDLT on residential property through corporate structures and issued a consultation document. There has been no further announcement on this. The Chancellor has announced that the SDLT disclosure rules will be extended to apply to residential property worth at least £1 million.

Notification and payment thresholds

Currently there are a number of situations when a land transaction return has to be submitted even where no SDLT is payable. The thresholds for notification are to be raised. A transfer of residential property will be notifiable only if there is consideration exceeding £40,000 (rather than £1,000). The grant of a lease for seven years or more will be notifiable only if any consideration other than rent exceeds £40,000 or where the annual rent is more than £1,000. If a transaction is not notifiable under these rules, neither a land tax return nor a self certificate is required.

The £600 rule for residential is to be removed. Currently if the annual rent payable under a lease exceeds £600 then SDLT is payable even where the usual thresholds (£150,000 for residential property and £250,000 for commercial property) are not exceeded. This rule will no longer apply to residential leases. For commercial leases the rule is retained with a minor increase in the threshold to £1,000.

These changes will apply from 12 March 2008.

Relief for new zero-carbon flats

The Finance Bill 2008 will introduce legislation to extend the SDLT relief for new zero-carbon homes to new zero-carbon flats. With effect from 1 October 2007 and until 30 September 2012, purchases of all new zero-carbon flats for a purchase price of up to £500,000 will be exempt from SDLT. If the purchase price is greater than £500,000, the SDLT liability will be reduced by £15,000. The relief will only apply to the first sale of the flats.

Contaminated land - Landfill tax

For waste disposed of after 1 April 2009 the standard rate of landfill tax will be increased by £8 per tonne to £40.

Landfill site operators and those disposing of waste cleared from contaminated land by landfill are exempt from landfill tax in respect of waste generated by the cleaning process. This exemption is to be removed. In order to qualify for the exemption currently, the operator/disposer must obtain a retail certificate from HMRC before disposing of the waste. Applications for exemption certificates will be accepted until 1 December 2008. Those who receive valid certificates under any application submitted before this deadline will still benefit from the exemption provided the disposal is made before 31 March 2012.

Landfill site operators can claim credit against their landfill tax bill for contributions made to certain environmental bodies. With effect from 1 April 2008 the credit will be reduced from 6.6 per cent to 6 per cent.

Capital Allowances and offshore funds

Section 1 above.

3. NON-DOMICILIARIES AND RESIDENCE

The changes to the rules relating to UK resident non-domiciliaries were announced in the Pre-Budget Report, and a note describing these changes was circulated on 15 February. The proposals announced at today's Budget largely reflect the anticipated changes, but there are a number of key refinements. This note recaps on the main changes and the refinements to these. A further updated more detailed note will follow.

Remittance basis - £30,000 charge

Currently non-domiciled or non-ordinarily resident persons (non-domiciliaries) do not pay UK tax on income and gains generated in respect of overseas assets unless the monies are remitted to the UK.

Under the new rules, as originally proposed, non-domiciliaries who have been resident in the UK for seven out of the last nine years will have to pay a £30,000 annual charge if they wish to continue to benefit from the remittance basis. However, this charge has been refined in a number of ways:

- It will only apply to non-domiciliaries with unremitted aggregate overseas income and gains for the year exceeding £2,000 (replacing the £1,000 limit originally proposed).
- It will only apply to those aged 18 or over.
- It will be a **tax on the individual's unremitted income or gains** rather than a stand-alone charge, and will therefore be treated as either income tax or CGT. This is designed to have two effects: the relevant unremitted income or gains will not be taxed again even if remitted to the UK, and the charge will be creditable income tax or CGT for the purposes of the UK's double tax treaties (including, importantly, the UK's treaty with the U.S.).

Personal allowance and CGT annual exemption

Non-domiciliaries claiming the remittance basis in a particular year from 2008/2009 will lose their income tax personal allowance and CGT annual exemption if their unremitted aggregate overseas income and gains for that year exceeds £2,000 – this replaces the £1,000 threshold contained in the original draft legislation.

Changes to remittance basis

The new rules include a number of measures aimed at preventing individuals circumventing the remittance basis.

Abolition of "ceased source" principle
Currently it is possible to remit overseas savings an investment income without attracting a UK tax charge if the remittance is made in a year in which the source of the income no longer exists. As originally proposed this will no longer be the case.

Bringing assets into the UK
Currently the remittance basis only applies to cash. Hence it is possible for individuals to convert overseas income into an asset and bring that asset into the UK without attracting a UK tax charge. As anticipated, bringing an asset purchased using overseas income to the UK will count as a remittance from 2008/2009 but there will now be some exceptions. The exceptions are for the following (provided the income is not employment income):

- personal effects (clothes, shoes, jewellery and watches),
- assets costing less than £1,000,
- assets brought to the UK for repair and restoration, and assets in the UK for less than 9 months.

In addition, works of art brought to the UK for public display will not count as a remittance, whether purchased using overseas income (whether or not employment income) or overseas gains.

Claims mechanism
Currently foreign savings and investment income arising in a year in which the remittance basis is claimed are not taxed if remitted in a year in which no remittance claim is made. As originally proposed, the rules will be changed to that such income will be taxable irrespective of the year of remittance and whether or not a claim for the remittance basis is made in that year.

Alienation
The law currently allows overseas income and gains to be alienated by a relevant individual to a third party which can then bring the monies into the UK in such a way that the remittance basis does not apply. Rules will be introduced to block this structure. The rules apply where the individual or his immediate family benefits in any way from the money or property brought into the UK. The definition of immediate family will now be limited to spouses, civil partners, individuals living together as spouses or civil partners and their children or grandchildren under the age of 18. It will also cover close companies or foreign companies which would be close if in the UK of which any such persons are participators and trusts of which any such persons are settlors.

Transfer of assets abroad

As originally proposed anti-avoidance legislation designed to prevent individuals from avoiding income tax by transferring assets abroad will be amended to ensure the rules apply to non-domiciled individuals

Tax

Capital gains tax losses

Currently non-domiciled individuals get no capital gains tax relief for losses arising offshore. From 2008/2009, only those non-domiciliaries using the remittance basis in a particular year will be prohibited from obtaining CGT relief for losses arising offshore. Those taxed on the arising basis will be able to obtain relief.

Offshore trusts

Previously offshore trusts and companies were commonly used as a tax shelter and/or as a means of bringing funds to the UK without attracting a charge under the remittance basis. As proposed, very broadly, the income and gains arising to offshore companies and trusts will be attributed to the relevant individual and so potentially be subject to UK tax so that such structures are largely rendered ineffective. However, the rules governing the CGT treatment of offshore trusts contained in the draft legislation have been significantly amended. Although the changes proposed are complex, they reflect a significant climbdown by the Government on its original proposals. Importantly:

- Non-domiciled beneficiaries who receive capital distributions from an offshore trust from 2008/2009 (except where those distributions are “matched” to trust gains realised before 2008/2009) and who use the remittance basis will be taxable on those distributions on the remittance basis (contrary to the original draft legislation).
- The trustees of offshore trusts will be given the option to rebase trust assets to their market value as at 6th April 2008, with the effect that only any subsequent gain will be potentially chargeable on a non-domiciled beneficiary.

Residence rules

The day-counting rules for determining whether an individual is UK resident have also been revised. The Pre-Budget Report proposed that days of arrival and departure would count as days of presence in the UK. It is now proposed that only days where the individual is present in the UK at midnight will be counted.